

Testimony of NYSE Interim Chairman and CEO John Reed

***“Reviewing U.S. Capital Market Structure:
The New York Stock Exchange and Related Issues”***

***Before the Subcommittee on Capital Markets, Insurance and Government
Sponsored Enterprises of the House Financial Services Committee***

October 16, 2003

Chairman Baker, Ranking Member Kanjorski and Members of the
Subcommittee:

My name is John Reed. Thank you for inviting me to testify today in connection with your review of the U.S. capital market structure, and in particular, the role of the institution that stands at the epicenter, the New York Stock Exchange. I assumed the role of Interim Chairman and CEO for a very focused but challenging task: to modernize the Exchange’s governance and leave behind a board and a leadership in which the public can place its trust.

I accepted this challenge in the wake of public disclosures that revealed that the Exchange’s governance had failed in how it set its executives’ compensation, and then failed again in how it met the crisis that resulted from disclosure of that compensation. These failures revealed a board too large and too conflicted to effectively govern the Exchange.

The NYSE's 31-year-old corporate governance structure has quite simply not kept pace with either developments in the best practices in corporate governance over the last three decades or the tremendous changes in the nature of our constituents. Specifically, the Exchange's governance must be revamped to manage conflicts of interest and increase transparency. The Exchange's governance must comply with the governance standards to which our listed companies adhere, and indeed, must go beyond those standards in order to meet the special challenge of serving as both a marketplace and the vehicle by which our members regulate themselves.

Before describing some of the governance changes we are working to implement, I want to address an important issue that underlies much of the discussion about the Exchange's governance failures: the issue of self-regulation. As you all know, self-regulation is at the core of our nation's securities laws and has been at the core of the NYSE since its formation more than 140 years before the adoption of the laws. Yet the governance failures at the Exchange have laid bare the conflicts inherent in self-regulation. Critics have seized on this to argue that the NYSE's regulatory arm be severed from the Exchange – in essence they are calling for the end of self-regulation. I respectfully but strongly disagree with that view.

Self-regulation places the regulators very close to the regulated, both physically and in terms of knowledge and experience. This proximity gives self-regulators insight into issues of regulatory concern and the ability to devise effective solutions that minimize interference with market mechanisms. Moreover, self-regulation is one of two legs of a larger regulatory regime that includes government regulation by the Securities and Exchange Commission and the Congress. The nation's best chance for assuring effective regulatory oversight of our securities markets and their participants does not lie in the direction of cutting off one of those two legs.

SEC Chairman William Donaldson told the Senate Banking Committee on September 30th (according to the *Wall Street Journal* of October 1) that, despite some "hiccups through the years," self-regulation has "worked pretty well." While the SEC and NYSE must work together to address conflicts that could impede the NYSE's ability to police its members, Chairman Donaldson said that "self-regulation is an important function due to the NYSE's expertise in market issues." Moreover, Chairman Donaldson noted that, while conflicts exist in the way members regulate themselves through the Exchange, it would be a "mistake to completely split off the Big Board's self-regulatory function." I agree with Chairman Donaldson.

Rather than splitting off the Exchange's self-regulatory function, the Exchange must adopt governance structures that manage the conflicts of interests inherent in self-regulation while maintaining the key advantages of self-regulation I've just discussed. How do we do this?

In response to a question from Senator Shelby regarding the self-regulatory structure of the NYSE, Chairman Donaldson recently noted that in the 1930s the Commission wisely included a self-regulation mechanism so there would not be a huge government bureaucracy. He said that it has worked well. He stated that the key issues are (1) how the regulatory function is financed and (2) where the regulatory function reports in the governance structure, in order to avoid potential conflicts of interest. These are indeed the important questions.

The reforms we are working to implement address both of these questions. The answers to both questions are the same – the NYSE Regulatory Group must have its budget set by, and must report to, a board of directors that consists of a substantial majority of directors who are independent, not just of the Exchange's management, but also of both the broker-dealer industry and the companies listed on the Exchange. And to better enable the SEC, the investing public, and indeed

the Congress to ensure we adhere to our public purpose, the Exchange's governance must be made transparent. Accountability will not be avoided.

Let me be as specific as I can at this point in our redesign of our governance architecture. We are contemplating a NYSE Board of Directors comprised of a substantial majority of independent directors that would exclude individuals from the Trading Floor and other parts of the broker-dealer industry, as well as current CEOs of listed companies. The independent directors will be responsible for discharging the Board's crucial governance functions, including nominating, compensation and audit functions, just as independent directors perform these functions under our governance standard for listed companies. And as noted, these independent directors will be responsible for regulatory oversight and regulatory budgeting.

Regarding transparency, consistent with proposed rules under consideration by the SEC for public companies, the Exchange will publicly disclose information about the Exchange's director nominating process and the means by which investors may communicate with the NYSE's independent directors. As applied by analogy to the Exchange, the SEC's proposed rule would, among other things, require disclosure concerning the Exchange's policy regarding consideration of individuals recommended by public investors as potential nominees to the

Board; the procedures public investors are required to follow for suggesting nominees; the process for identifying and evaluating nominees; and any differences in evaluation if the nominee is recommended by a public investor. In addition, the Nominating Committee will establish a procedure to solicit recommendations from the investing public for nominees to the Board.

We will report annually and publicly on the compensation of the five most highly compensated officers of the Exchange (as well as director compensation) and provide detailed information on the compensation philosophy and methodology used to award that compensation. This detailed information will include information relating to appropriate industry comparisons, benchmarks, performance measures and evaluation processes. Let me note here that we have already disclosed substantially more historical compensation information regarding NYSE executives than our securities laws require of public companies.

The Exchange will also disclose relationships among the NYSE and its directors and executive officers, and how the Exchange addresses any conflicts that may arise from those relationships. Additionally, transparency demands that the Exchange make public disclosure of charitable contributions made by the Exchange and the NYSE Foundation, and we will do that as well. And consistent with the NYSE's new listing standards, the Exchange will annually publish its

written Governance Principles, Codes of Ethics, and Board committee charters as well as the names of Board committee members.

By creating an independent Board charged with oversight of the Exchange's critical governance, control and regulatory functions and through transparency, I believe we will have applied the hard-won lessons of the Exchange's governance debacle.

I've spent a great deal of my time this morning addressing issues of self-regulation and governance. But lost in the swirl of recent events is the fact that the NYSE is a singular institution that has served American investors exceptionally well for many generations. Amidst its governance crisis, the NYSE continues to provide the deepest liquidity and the best executions for listed-stock trades; it continues to offer investors a range of reliable execution choices; it continues to attract listings of companies from across the country and around the world willing to adhere to our high standards; and importantly, it continues to offer fair markets backed up by a vigorous and effective regulatory program.

When considering reforms to the NYSE's governance, we must recognize the crucial role the NYSE plays in the global economy and our national well-being – it is a marketplace where nearly \$40 billion of corporate securities change hands every day, it is the primary self-regulatory mechanism of the nation's

major broker-dealers, it is the source of stringent corporate governance standards for issuers that choose to list their securities on the NYSE, and it gives voice to its constituents on public policy issues affecting our capital markets. As stewards of the world's preeminent venue for trading shares, we are charged with discovering the right steps to ensure public confidence in the Exchange while making even better what is already working so well at the Exchange.

As noted at the outset, it is my mission to address these governance issues head on before making way for a permanent NYSE chairman. But I know the members of this Subcommittee are deeply interested not only in making sure the Exchange incorporates the best governance practices and restores public trust, but also in assuring the resolution of the issues of market structure currently under review by the SEC under Chairman Donaldson's leadership in a way that enhances the quality, cost-effectiveness and competitiveness of our capital markets. My expertise is not securities market structure, and my brief time at the Exchange has not provided me with the experience to address these issues with you in great detail, though there are experienced and knowledgeable professionals at the Exchange who can and who are available to the Subcommittee at any time. I do however want to respectfully suggest that critics of the Exchange's agency-auction market structure not use the Exchange's governance crisis to avoid a candid and principled

discussion about market structure issues. Our nation's capital markets are simply too important to confuse the two sets of issues.

Those who suggest the NYSE's physically-convened market is outmoded in a digital era ignore the tremendous amount of technology brought to bear at the point of order execution on the floor the NYSE, including the choice provided to investors of an automatic electronic order execution. The simple fact remains – the NYSE attracts the deep liquidity that makes markets work efficiently and does so in a way that puts the individual investor on a level playing field with the largest institutional investors. There are those who have their own interests in seeing the Exchange's liquidity fragmented among other trading venues. One does not have to be an expert in securities market structure to appreciate that fragmentation can impair the price discovery performed by equity markets and do so in a way that disadvantages the individual investor.

To conclude, I want to assure you that we understand the damage done to the Exchange's reputation as a result of its governance failures and that we are on the right path to creating a governance process that meets today's needs. We will bring greater independence to the Board table to reduce and manage conflicts of interests and greater transparency in our governance processes to ensure accountability. We will do this without losing sight of the critical business of the

NYSE – the business of operating the world’s deepest and fairest equity market for the benefit of investors and listed companies.

Again, thank you for the opportunity to appear before you today. I’d be happy to answer your questions.